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MICHAEL RODAK, JR.

In the Supreme Court
of the United States

OCTOBER TERM, 1974

No. 74-1651

RICHARD A. CLARK, JAMES H. EVANS, WESTON M. LENNOX, DAVID A. MOFFAT, SAMUEL L. SAVIDGE, GEORGE L. ZIMMERMAN and HELEN D. BLOOMFIELD,
Petitioners,

v.

H. R. WATCHIE and SHEILA WATCHIE, his wife, H. R. WATCHIE & ASSOCIATES, INC., a Washington corporation, E. JOSEPH McCAMBRIDGE and JANE DOE McCAMBRIDGE, his wife, GENE LYNN and JANE DOE LYNN, his wife,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioners respectfully pray for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit to review the portion of the judgment and opinion of that court which affirmed a district court's denial of class action status to petitioners' securities fraud suit against respondents.

OPINIONS IN THE COURTS BELOW

Pretrial proceedings in the district court were referred to a bankruptcy referee as a special master. He filed a report which concluded that the suit did not qualify as a class action. The district court then denied petitioners' motion for class action status. That determination was affirmed by the court of appeals. The report of the special master and the order of the district court are not reported. The pertinent portion of the opinion of the court of appeals appears at 19 FR Serv2d 1496. Copies of the special master's report, the district court order and the opinion of the court of appeals are included in the appendix to this petition.

JURISDICTION OF THIS COURT

The judgment of the court of appeals was dated and entered April 2, 1975. The only petition for rehearing was a petition by respondents with respect to matters that are not material to this petition to this court. The petition for rehearing was denied by order dated June 5, 1975 and docketed June 6, 1975. There has been no application for any extension of time within which to petition for certiorari. This court has jurisdiction to entertain this petition pursuant to the provisions of 28 U.S.C. § 1254(1).

THE QUESTIONS PRESENTED FOR REVIEW

1. Where there is a single scheme to defraud which

involves the sale of securities without disclosure of adverse facts about them, may there be a class action on behalf of all defrauded investors provided that the common issues predominate over the individual issues, atlhough the facts concealed are not established to be identical as to each investor?

2. Under Rule 23 of the Rules of Federal Procedure, does a district court have discretion to deny class status to a suit under S.E.C. Rule 10b-5 for the reason that the securities were sold with oral representations, if there is a common core of fraudulent conduct and the questions of law and of fact that are common to all members of the class clearly predominate over questions effecting only individual members?

RULES AND REGULATIONS INVOLVED

This petition involves Rule 23 of the Rules of Civil Procedure for the United States District Courts and S.E.C. Rule 10b-5, 17 C.F.R. § 240, 10b-5. The text of those rules are set out in the appendix to this petition.

STATMENT OF THE CASE

Certain purchasers of limited partnership units in a multi-million dollar land syndicate (Cougar Mountain partnership) filed a class action complaint on behalf of all purchasers of the units. Petitioners alleged that there was a conspiracy and scheme to defraud members of the public by the sale of those partnership

units in violation of S.E.C. Rule 10b-5. The district court therefore had jurisdiction of the action pursuant to § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa.

Respondent H. R. Watchie became the general partner of the Cougar Mountain partnership. H. R. Watchie & Associates, Inc. (Associates) was the underwriter of the sale of the partnership units. Respondents Gene Lynn and E. Joseph McCambridge are claimed to have been controlling persons of Associates, aiders and abettors of it and participants in the conspiracy and in the sale of the units (A 30, 57-59).*

The alleged conspiracy included a plan of respondents to create a real estate syndicate that would pay several million dollars to buy real estate at inflated prices. The land was located in an area where Associates allegedly had created an artificial real estate market. That market is claimed to have been created by inducing the buying and selling of tracts of unimproved land between small syndicates organized by Associates. The syndicates were made up of unsophisticated investors. They relied upon Associates and its personnel for decisions as to what land they should buy, what they should pay for it, when they should sell it and how much they should charge for it. In many cases the investors did not even see the land which their syndicate purchased (A 42-43, 61).

* References are to pages of the appendix. It is separately presented.

Most of the sales by one such syndicate to another were at prices which were exactly double the amount that the seller had paid for the property. Associates received a 10% commission on each such sale. The ultimate total amount of commissions on repeated sales of a tract between Associates dominated syndicate groups sometimes approached or exceeded the price originally paid to a stranger for the property (A 45-46).

Petitioners claim that a real estate bubble had been created and that a main purpose of the conspiracy was to prevent the bubble from bursting. The new multi-million dollar syndicate would buy the properties of the various small syndicates, usually at double the prices paid for them by the small groups of investors. The property would then be held until anticipated increases in market values made the land worth the doubled and redoubled prices. Petitioners contend that respondents assumed that pooling all of the real estate interests in one limited partnership would make it impractical for any investor to determine if the prices paid for partnership properties were reasonable or excessive (A 44-49).

The sale of all the properties to the partnership would also result in additional 10% real estate commissions for Associates. That would enable it to pay large sums of money to the individual respondents (A 47).

It is claimed that the plan was also calculated to eliminate any risk of legal action by earlier investors

who had been induced to pay doubled prices for property. Those purchasers would themselves receive double their purchase prices by resales to the Cougar Mountain partnership (A 47-48, 62).

It allegedly was part of the plan of the conspirators that units of limited partnership interests in the new syndicate would be sold to members of the public without disclosure of the facts relating to respondents' alleged intent to use the partnership to "bail out" the earlier investors. Petitioners further claim that as part of the plan other material matters would be and were concealed from purchasers of the partnership units and that false statements and half truths would be and were used in the sale of the units (A 50-57, 63-70).

The sales program consisted of a series of meetings at clubs and restaurants in the Seattle area. Mr. Watchie would give a memorized sales presentation and then answer questions. Following the memorized presentation by Watchie prospective investors would be solicited by salesmen employed by Associates on a commission basis. They were instructed to quote or paraphrase Mr. Watchie's memorized presentation but not to add to it (A 70).

In moving for class action status petitioners made it clear that in establishing liability they would not rely upon false statements, if any, of the salesmen.

> "Defendants contend that there should be no class action because some of the oral representations of salesmen may have been false and may have varied from one investor to another. Plaintiffs' attorney has represented in open court, and now confirms, that plaintiffs do not rely upon any such misrepresentations, if they occurred. Plaintiffs' reliance is upon concealment of the same facts from all members of the class; misrepresentations in the written material given in identical form to all investors and upon half truths included in the memorized sales presentation of H. R. Watchie that was given at all of the sales meetings." (R. 455-456).

The sale of the limited partnership units in the new land syndicate proved to be successful. Large sums of money were raised. The partnership paid $5,500,000 for some 43 properties which had been acquired by the small syndicates for a total sum of $2,800,000 during the three years preceding the formation of the partnership. Twenty-six of the properties were sold to the new partnership at exactly double the prices which the smaller syndicates had paid for the same tracts (A. 26).

The Securities and Exchange Commission obtained an injunction against Associates restraining collection of further installment payments on the Cougar Mountain limited partnership units until there was full disclosure of material facts to the limited partners. An appropriate report was prepared by Associates under the observation of the staff of the Securities and Exchange Commission. Copies of the disclosure report were distributed to the limited partners.

Some time later this private civil action was filed as a class suit on behalf of the purchasers of the partnership units.

ARGUMENT

Summary of Argument

The decision of the court of appeals in this proceeding permits those who sell securities by fraud to insulate themselves from class suits by simply causing oral representations to be made to their victims. The correctness of that ruling is an important matter that has not been determined by this court. The decision of the Ninth Circuit is in conflict with a decision of the Tenth Circuit and conflicts in principle with decisions of the Second Circuit.

Important Question of Federal Law Not Yet Settled by This Court

The importance of class actions in enforcement of federal securities laws was recognized by the Second Circuit in *Green* v. *Wolf Corporation et al*, 406 F.2d 291, 295, cert. den. 395 U.S. 977 (1969):

> "We are mindful that the serious and troublesome question as to when to allow a class action under 10b-5 is of great importance. This is so because '[t]he ultimate effectivenes of the federal remedies when the defendants are not prone to settle may depend in large measure on the applicability of the class action device.' 3 Loss, Securities Regulation 1819 (2d ed. 1961)"

The Ninth Circuit decision in this case effectively withdraws any class action remedy from defrauded securities purchasers who received oral representations from the seller or the seller's agents or salesmen.

The Court of Appeals for the Ninth Circuit held:

> "Appellants must show, as a condition to class status, that any misrepresentations or non-disclosures were common to the class. They have not shown that the alleged misrepresentations and non-disclosures involved every limited partner."

Subdivision (b)(3) of Rule 23 of the Federal Rules of Civil Procedure requires a finding:

> ". . . that the questions of law or fact common to the members of the class predominate over any questions effecting only individual members."

The Ninth Circuit now has added an additional requirement with respect to suits under S.E.C. Rule 10b-5. The class representative must also establish that any misrepresentations or non-disclosures were common to the class. This is probably impossible for a class that consists of dozens or hundreds of persons. It becomes patently impossible if some years elapse before the fraud is discovered.

It is respectfully submitted that the correctness of this additional requirement for a 10b-5 class suit presents an important question of federal law which has not been, but should be, settled by this court. If the ruling below is permitted to stand, any dishonest person who devises a scheme to defraud, which involves the sale of securities, can effectively insulate himself from danger of a class action suit on behalf of his victims by causing them to receive oral representations about the securities.

Under the Ninth Circuit decision, the class action

for violation of Rule 10b-5 continues to be an effective (perhaps overly effective) weapon in certain circumstances, such as a suit against a national accounting firm which makes an error of judgment in its footnoting of a financial statement. Unlike the thief who deliberately carries out a scheme to defraud, the accounting firm cannot protect itself from class suits by causing the use of oral representations. Yet, if there is to be any difference in the degree of exposure to a meaningful 10b-5 lawsuit, which must be brought as a class action, the difference should favor the honest man rather than the scoundrel.

The Ninth Cricuit has misconstrued Rule 23. That rule does not require disclosures or nondisclosures which are identical for every class member in a 10b-5 suit. The rule merely requires that common issues of law or of fact predominate over individual issues. There is express provision for sub-classes in the event that class members do not all fit into exactly the same mold.

A correct determination as to whether individual or common issues predominate requires examination of all of the issues in a class suit. There is no simple formula. One may not say that written representations mean that common issues predominate but that existence of oral representations establishes that individual issues predominate. In many 10b-5 actions the representations or omisisons will not result in any important issue.

An example is the relatively common situation

where a rigged market is created for the freely tradable but worthless stock of a shell corporation. In a suit by defrauded buyers the predominate issue is not whether the worthlessness of the stock was or was not disclosed to some or all of the investors. No one will contend that it was disclosed to any purchaser. Most of the defendants are likely to claim instead that no such disclosure would have been proper for them, because they believed that the stock was valuable. The true issues in the action will concern the overall scheme to defraud, any asserted favorable prospects of the corporation, the alleged rigging of the market and the identity and responsibility of the people who were involved, in one way or another, in the acquisition of a large block of the worthless stock and its eventual resale at substantial prices.

Petitioners submit that the Court of Appeals for the Ninth Circuit has failed to heed the frequent admonition of this court that courts must be alert to provide effective remedies for violations of the securities acts. *SEC* v. *Capital Gains Bureau*, 375 U.S. 180, 195 (1963); *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 386 (1970). On the contrary, the ruling of that court of appeals to some extent threatens the effectiveness of the private action as one means of enforcing the policy of the United States with respect to the purchase and sale of securities. There appears to be analogy to the situation in *Perma Life Mufflers* v. *International Parts Corp.*, 392 U.S. 134, 136 (1968):

"Because these rulings by the Court of Ap-

peals seemed to threaten the effectiveness of the private action as a vital means for enforcing the antitrust policy of the United States, we granted certiorari."

Direct Conflict with Decision of Tenth Circuit

The decision of the Ninth Circuit in this matter is in conflict with the Tenth Circuit decision in *Esplin* v. *Hirschi*, 402 F.2d 94 (1968), cert. denied 394 U.S. 928 (1968). *Esplin*, like this case, was a private action under S.E.C. Rule 10b-5 for fraudulent sale of securities by oral representations. In both cases the district judges held that because the oral representations were made the individual issues predominated and the suits should not proceed as class actions.

In each case there was an allegation of complete failure to disclose certain material facts to any purchaser of the securities. The Tenth Circuit held that the common questions "were sufficiently predominate for a 23(b)(3) type of class action." (402 F.2d at 100). That court recognized that the representations which had been made were oral.

> "It was undisputed that defendants did not deliver a prospectus to any of the investors . . ." (402 F.2d at 96)
>
> . . . . .
>
> "We are thus faced with the question of whether the trial of Rule 23 in not allowing this class action to proceed. Undoubtedly the possibility exists that there will be questions of individual oral misrepresentation to each of the potential

> plaintiffs relating to their inducement in buying the securities and in lulling them sufficiently to toll the statute of limitations. On the other hand, an examination of the Second Amended Complaint filed by the plaintiffs shows that the real basis of their allegations concerns the failure of the defendants to make any representations concerning relevant and material facts, i.e., certain omissions of material facts common to all purchasers. . . ." (402 F.2d at 98-99)

The contrary decision of the Ninth Circuit in this proceeding affirmed the action of the district court in denying petitioners' class action motion. The court of appeals went further. It established a requirement for securities fraud class suits which will have the practical effect of preventing such suits in the Ninth Circuit whenever securities are sold by means of oral representations or by means of written material that is not identical for each purchaser.

Petitioners respectfully submit that the conflict should be resolved by this court.

Conflict in Principle with Decisions of the Second Circuit

In *Green* v. *Wolf Corporation, et al.*, supra, (406 F.2d at 300), the Second Circuit held that where there was a common course of conduct, designed to continually manipulate the market price of stock, there was a violation of section 10b-5 which constituted a common question under Rule 23. The fact that there were some differences in the written representations that

were made to different members of the class did not prevent the use of Rule 23.

> "If we were to deny a class action simply because all of the allegations of the class do not fit together like pieces in a jigsaw puzzle, we would destroy much of the utility of Rule 23."

Green v. *Wolf Corporation* did not involve oral representations. Yet it presents a conflict in principle with the Ninth Circuit decision in this proceeding. The Second Circuit requires that the common issues predominate but, unlike the Ninth Circuit, it permits divergence in the representations if other factors cause the common issues to predominate.

A more recent Second Circuit decision makes it clear that, in that circuit, securities fraud cases may be recognized to involve an elaborate scheme to defraud and that not all such suits should be deemed to be based primarily upon misrepresentations or concealment of facts. See: *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Howarth & Howarth*, — F.2d — (1975), C.C.H. Fed. Sec. L. Rep. ¶ 95,090, page 97,866.

> "Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws. In the case before us, plaintiff has charged the accounting defendants not only with affirmative misrepresentations in the financial statements, but also with a failure to disclose the true

> financial condition of Takara Partners and the alleged receipt of payoffs in return for its certification; furthermore, both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud. Under these circumstances, plaintiff need only show causation in fact; in order to do so plaintiff should have the opportunity to prove, but is not required to prove, that it saw, or directly relied upon, the financial statements certified by the accounting defendants. *Cf. Hochfedler* v. *Ernst & Ernst*, 503 F.2d 1100, 1115 (7th Cir. 1974)."

While there are great factual differences between *Green* v. *Wolf Corporation* and the instant matter it is respectfully submitted that the securities fraud class action concepts demonstrated in the one are so contrary to those shown in the other that the conflict should be resolved by this court.

This Proceeding is Appropriate for Use in Resolution of the Questions Presented

If the court should conclude that either or both of the questions presented in this petition are of sufficient importance to justify resolution by this court, the facts in this proceeding are well suited to provide opportunity for definitive answers to the questions.

Petitioners claim, and propose to prove, that the representations that were made (and those that were not made) in the sale of the partnership units followed a common pattern. Investors were given a copy of the articles of limited partnership. It allegedly con-

tains some false statements. They next listened to a memorized speech by Watchie and then were approached by salesmen who were instructed to quote or paraphrase Mr. Watchie's speech but not to add to it. The salesmen worked on commission. They may have had temptation to embellish but they had no motivation to volunteer information that would deter prospects from buying the units. Further, petitioners expressly waived any right to rely on false statements, if any, made by the salesmen.

No respondent contends that the investors were advised that Associates had created an artificial market in real estate and that the Cougar Mountain partnership was planned and created in order to "bail out" the investors in that artificial market by purchasing their properties at doubled and redoubled prices. Respondents deny any artificial market or "bail out." They claim that all property sales were at fair prices.

When the case is tried the real issues which will require most of the court's time and attention will not be issues of misrepresentation or non-disclosure. The major issues will include: (a) Was there an artificial market? (b) Was there a conspiracy to defraud, and if so, who joined in it? (c) Who were the controlling persons of Associates when the sale of the partnership units was planned and accomplished? (d) Who, if anyone, aided and abetted Associates? (e) What was the reasonable value of each of the 65 parcels of property purchased by the Cougar Mountain partnership? (f) Which, if any, of the statements

in the printed copies of the partnership articles were false?

The above list does not include all of the important issues which must be resolved at a trial. Even that brief listing of disputed matters makes it clear that misrepresentation and non-disclosure matters are dwarfed by the other issues in the action.

CONCLUSION

A writ of certiorari should issue to review the judgment and opinion of the Ninth Circuit.

Respectfully submitted,

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